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PRIVATE EQUITY PRIMER

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WHAT IS PRIVATE EQUITY?

- Private equity is any investment representing an ownership interest where there is no readily tradable or public market.

CHARACTERISTICS	PUBLIC EQUITY	PRIVATE EQUITY
AVAILABLE INVESTMENTS	• Approximately 63,000 companies worldwide (Bloomberg).	• 65,000,000 private companies worldwide (Hoovers).
INVESTMENT SECURITY	• Minority equity participant with limited control or influence.	• Often control equity ownership, but in some cases various debt positions are available.
BUSINESS CYCLE ACCESS	• Typically only mature or growth businesses are eligible to be public.	• Availability to invest in any phase of the business life cycle (seed investments through distressed).
BARRIER TO ACCESS	• Can be accessed through any registered broker.	• Invitation only (available only to qualified investors as defined by the Securities Act of 1933).
LIQUIDITY	• Often provide for daily liquidity options.	• Return of capital investment and returns over 10-12 year period, with no discretionary liquidity option.
VALUATIONS	• Daily valuations based on market pricing.	• Quarterly valuations on unrealized investments and available market pricing on divestitures.
RETURNS	• Historical average return expectations of 6-8.5% with a mean of 8%[1].	• Current average return expectations of 12%-17% with a median of 15%[1].

[1]J.P. Morgan Asset Management Long Term Capital Market Return Assumptions

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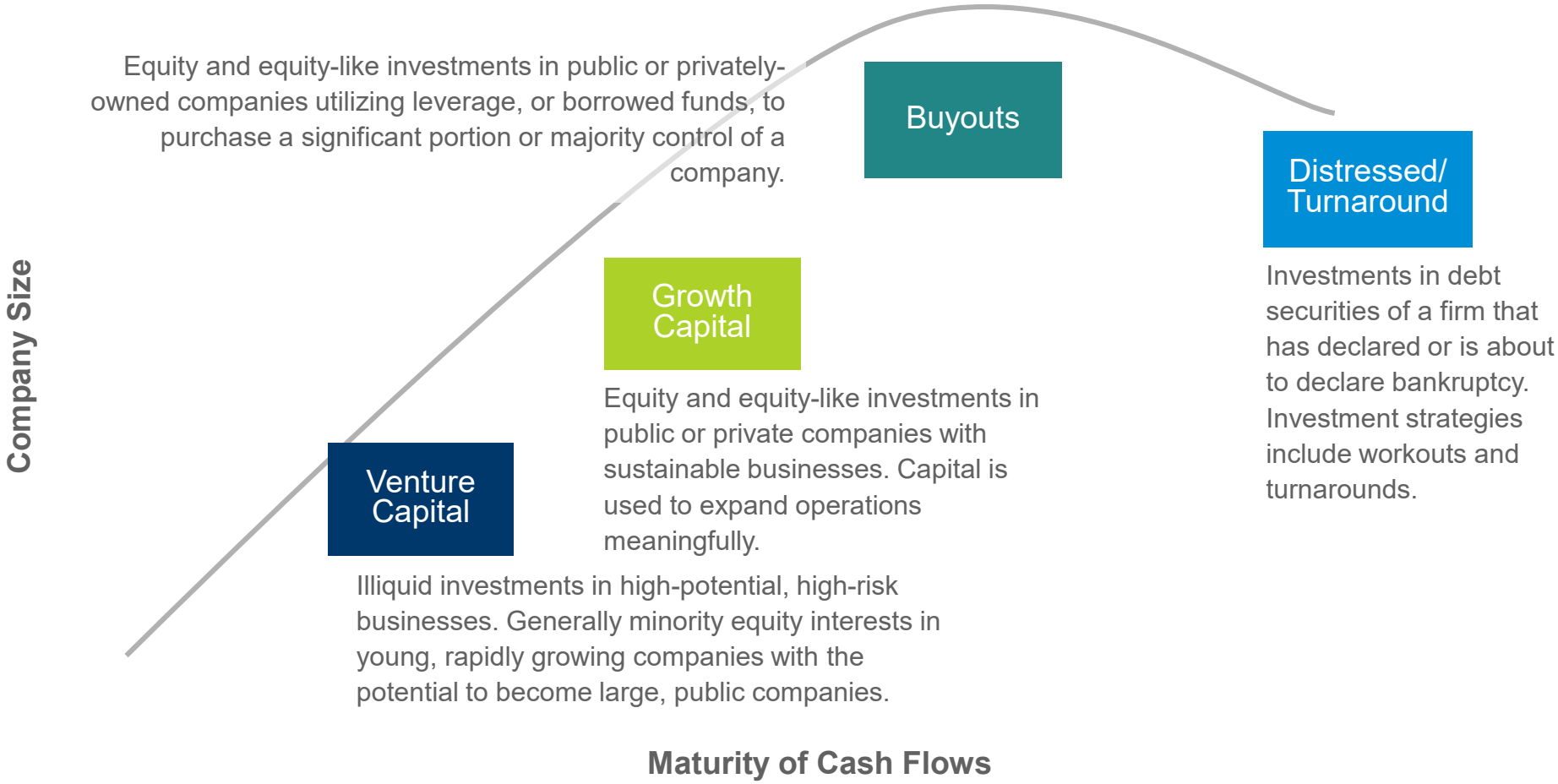
PRIVATE EQUITY INVESTMENTS DURING COMPANY LIFECYCLE



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DIFFERENT CHARACTERISTICS

	VENTURE CAPITAL	GROWTH EQUITY	BUYOUT	DISTRESSED
Portfolio Company Stage	Early-Late	Expansion	Mature	Little to no growth
Revenues	None / Low but growing	Substantial growth	Self-sustaining	Mature and eroding
Number of Fund Investors	Multiple	One or multiple	One or multiple	One or multiple
Management Involvement	Moderate-Heavy	Moderate	Heavy	Heavy
Financing Rounds by Investors	3 -5	1-3	Often 1	Often 1
Use of Debt	Rarely	Rarely	Almost always	Always
Source of Quarterly Valuations	New financing rounds Fair market value	Comparables Fair market value	Comparables Fair market value	Comparables Fair market value
Failure Rate	Meaningful	Sometimes	Infrequent	Infrequent

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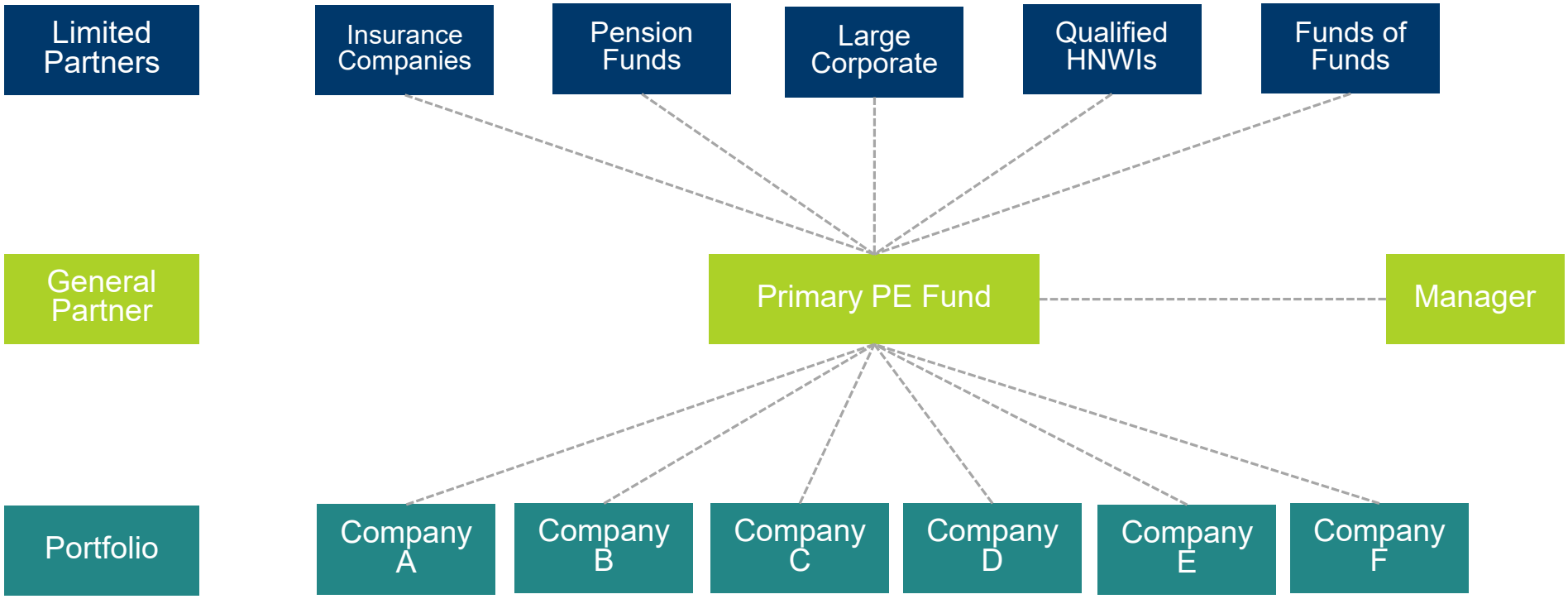
PRIVATE EQUITY INVESTMENT VEHICLES

- Most primary private equity fund investment opportunities are structured as limited partnership commitment vehicles.



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PARTNERSHIP STRUCTURES & FEES

STRUCTURE

- The primary vehicle is the private limited partnership that is not registered with the SEC.
- Limited partnership is managed by the general partner.
- Partnerships are long lived, ranging from 10–12 years.
- The partnership draws capital from LPs to fund investments over a specified investment period, then distributes capital back to LPs as investments are liquidated or sold.

FEES

- Typically, the manager charges the limited partner an annual management fee along with performance fees, or “carried interest” which represents a portion of the profits above a stated hurdle rate.
- Management fees on direct fund investments typically range from 1.5-2.5% annually, and are charged on committed capital. Fees are reduced after the investment phase.
- Hurdle rates can range from 8-15% with carry ranging from 5-20%.

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PRIVATE MARKETS CASH FLOWS

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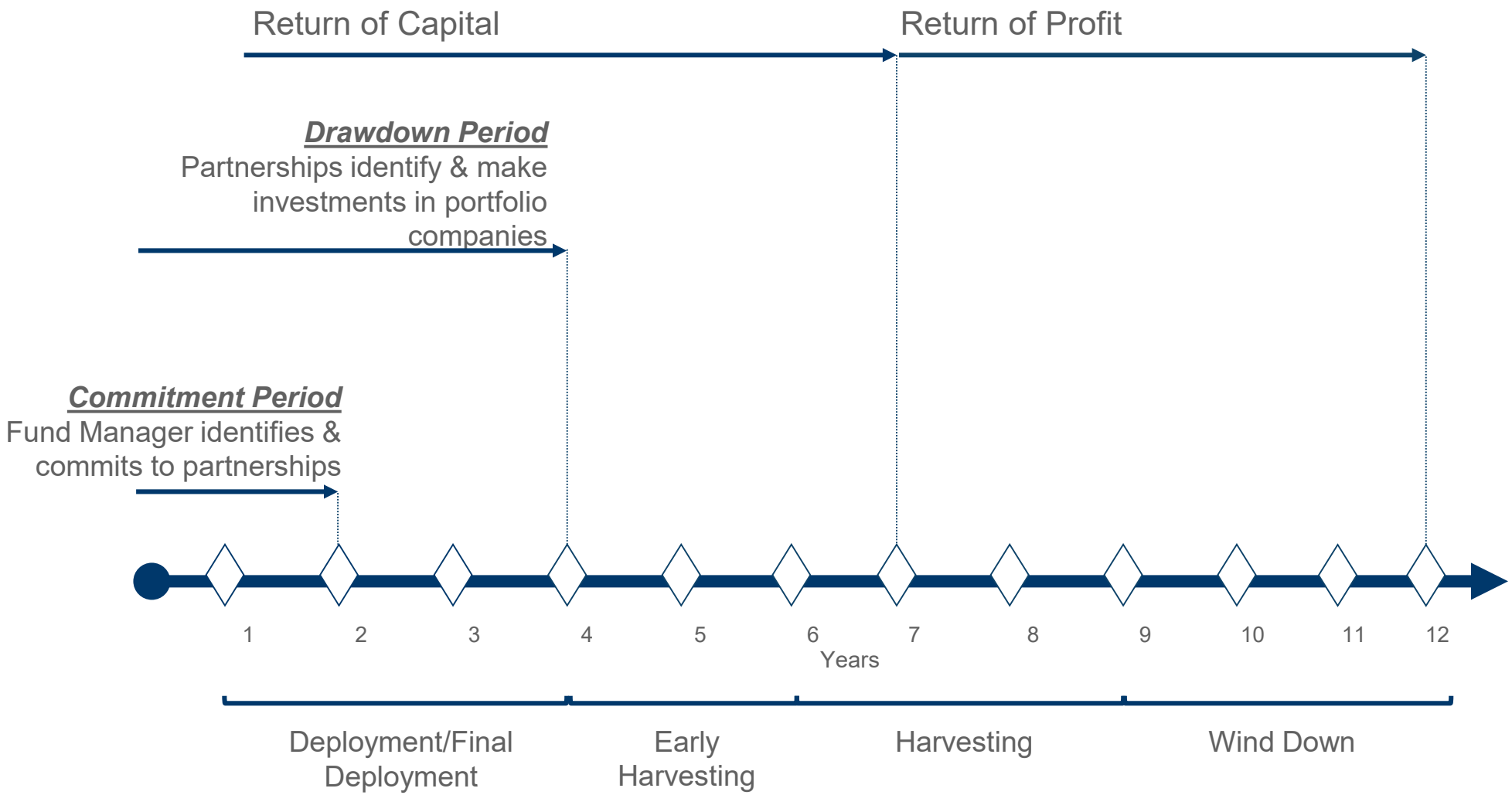
PRIVATE EQUITY CASH FLOW CYCLE



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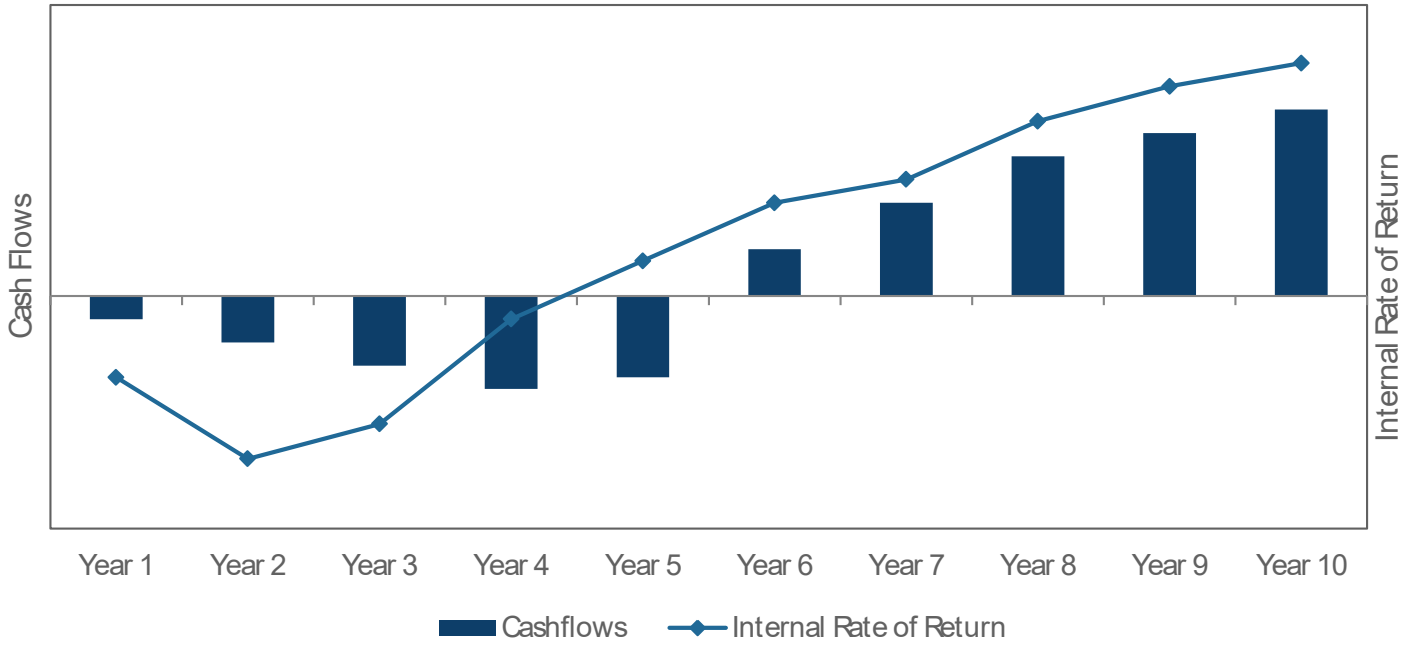
IMPLEMENTATION

UNDERSTANDING THE "J-CURVE" EFFECT

- The investment cycle of a private equity investment is long and exhibits a pattern referred to as the "J-Curve".
- Investors can expect early losses in the first few years of each investment.
- Losses are largely the result of manager fees.
- It stresses the importance of portfolio construction modeling to mitigate risk.



The chart shown here is for illustrative purposes and is not meant to represent any specific investment or the returns of any specific investment.

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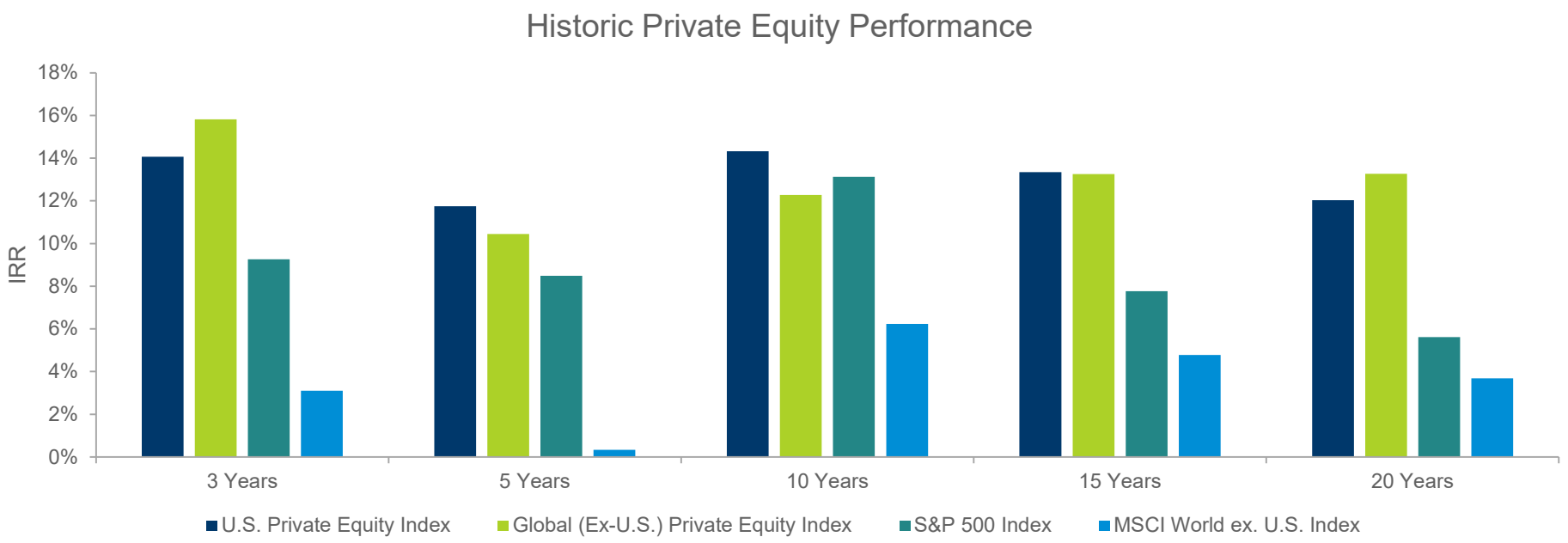
WHY INVEST IN THE PRIVATE MARKETS?

THE BENEFITS OF PRIVATE EQUITY INVESTING

- Private equity as an asset class has generated returns, net of all fees and expenses, in excess of diversified public market alternatives over a range of different time periods.
- Portfolio diversification with lower volatility than public equity market exposure
- Ability to invest at various stages of company development from early-stage venture capital through expansion, to later-stage investments in mature buyouts or distressed companies



Source: Cambridge Associates, as of December 31, 2018.

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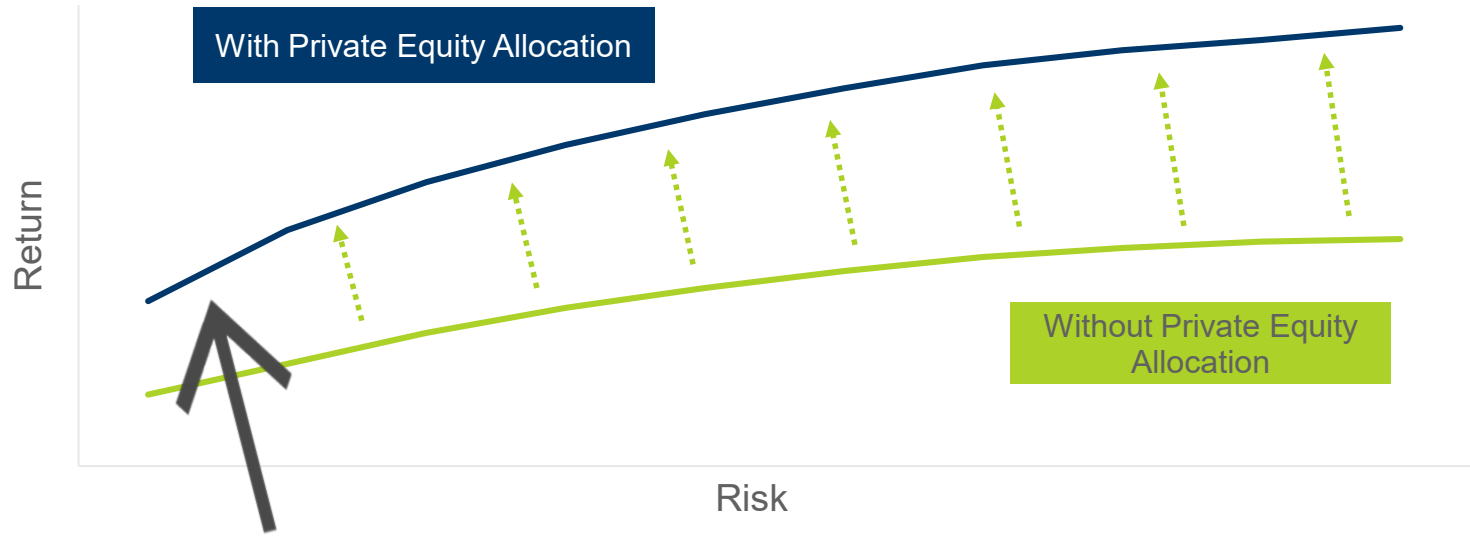
PRIVATE EQUITY IN A PORTFOLIO

- The decision to include a private equity allocation in your portfolio should be made as a top-down asset allocation decision.
- The inclusion of a private equity allocation in a well diversified portfolio may improve an investor's risk/return profile.

Portfolio Benefits from a Private Equity Allocation



Objective: Push the efficient frontier out to improve risk/return profile

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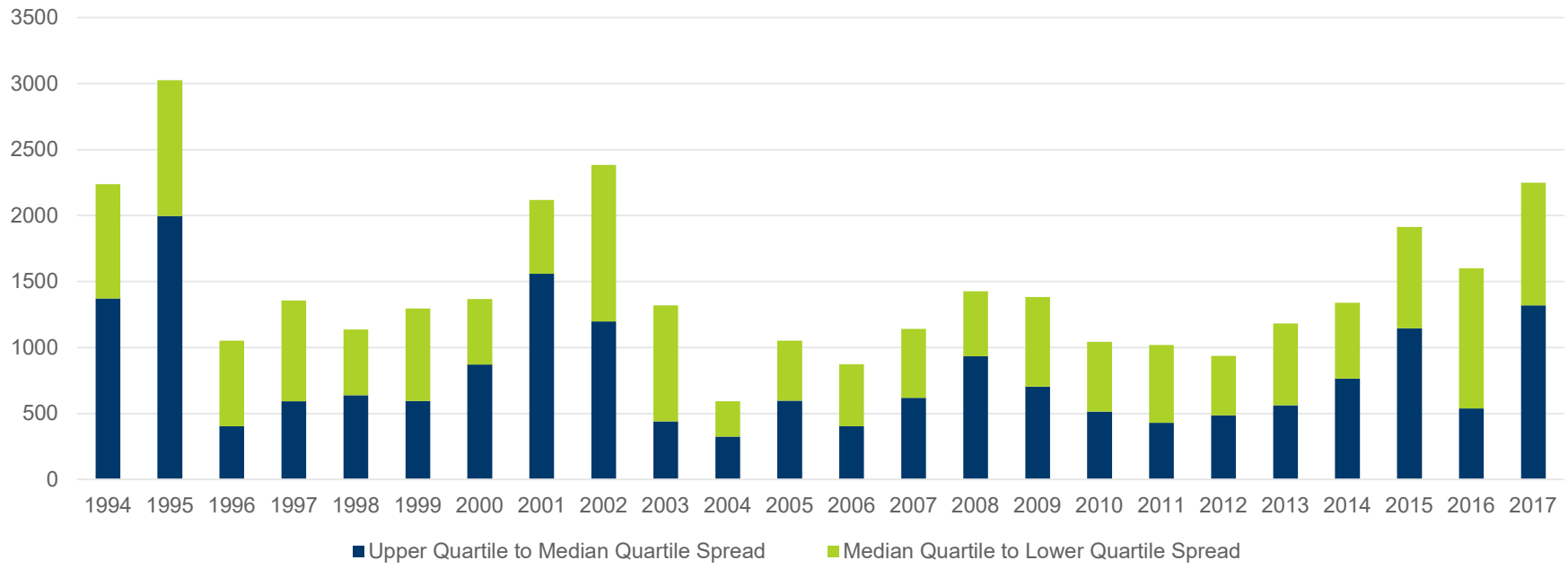
THE PRIVATE EQUITY MARKET OPPORTUNITY

- The dispersion of private equity returns is significantly larger than that of other asset classes, highlighting the importance of manager selection.
- Top-quartile managers in earlier funds continue to outperform other managers in subsequent funds.

HISTORICAL INTERQUARTILE SPREAD FOR U.S. PRIVATE EQUITY FUNDS



Source: Cambridge Associates as of December 31, 2018. Asset classes include buyout and growth equity, private equity energy and mezzanine funds.

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THE PRIVATE EQUITY MARKET OPPORTUNITY

CURRENT PRIVATE EQUITY OPPORTUNITY

- Vintage year diversification reduces the cyclical nature of investment performance.
- Potential upward valuation of investments from current depressed valuations over the next 5-7 years, as global economic recovery occurs
- Growing number of private equity investment opportunities in developing markets, particularly in the Asia-Pacific region
- Scarcity of investment and expansion capital for smaller and medium-sized companies in the developed markets of the U.S. and Europe
- Selective opportunities in distressed strategies

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THINGS TO CONSIDER

THINGS TO CONSIDER BEFORE INVESTING IN PE

SUITABILITY

- Private equity funds are not suitable for all investors. Prospective investors are required to meet minimum financial eligibility guidelines (typically “accredited investor” or “qualified purchaser” requirements) to invest in private equity.

LONG-TERM INVESTMENT HORIZON

- Private equity funds are generally set up as 10–12 year investments with little or no provision for investor redemptions.

DIFFICULT VALUATION ASSESSMENT

- The portfolio holdings in private equity funds may be difficult to value, because they are not usually quoted or traded on any financial market or exchange, which makes it hard to quantify the impact a manager has had on underlying investments until they are sold.

LACK OF LIQUIDITY

- Private equity funds are not liquid (they can’t be sold or exchanged for cash quickly or easily), and the interests are typically nontransferable without the consent of a fund’s managing member.

LEVERAGE

- Private equity funds may use leverage in connection with certain investments or participate in investments with highly leveraged capital structures.

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BUILDING & MANAGING A PRIVATE MARKETS ALLOCATION

- Develop expectations
- Create long-term optimal portfolio
- Investment type – primary, secondary, co-investment
- Utilize pacing model

- Geographical diversification
- Vintage year diversification
- Diversification by sector / industry

- Performance measurement and reporting
- Portfolio monitoring
- Partnership amendments

- Develop forward calendar of opportunities
- Initial screening
- In-depth investment due diligence
- Operations due diligence
- Legal review
- Portfolio construction

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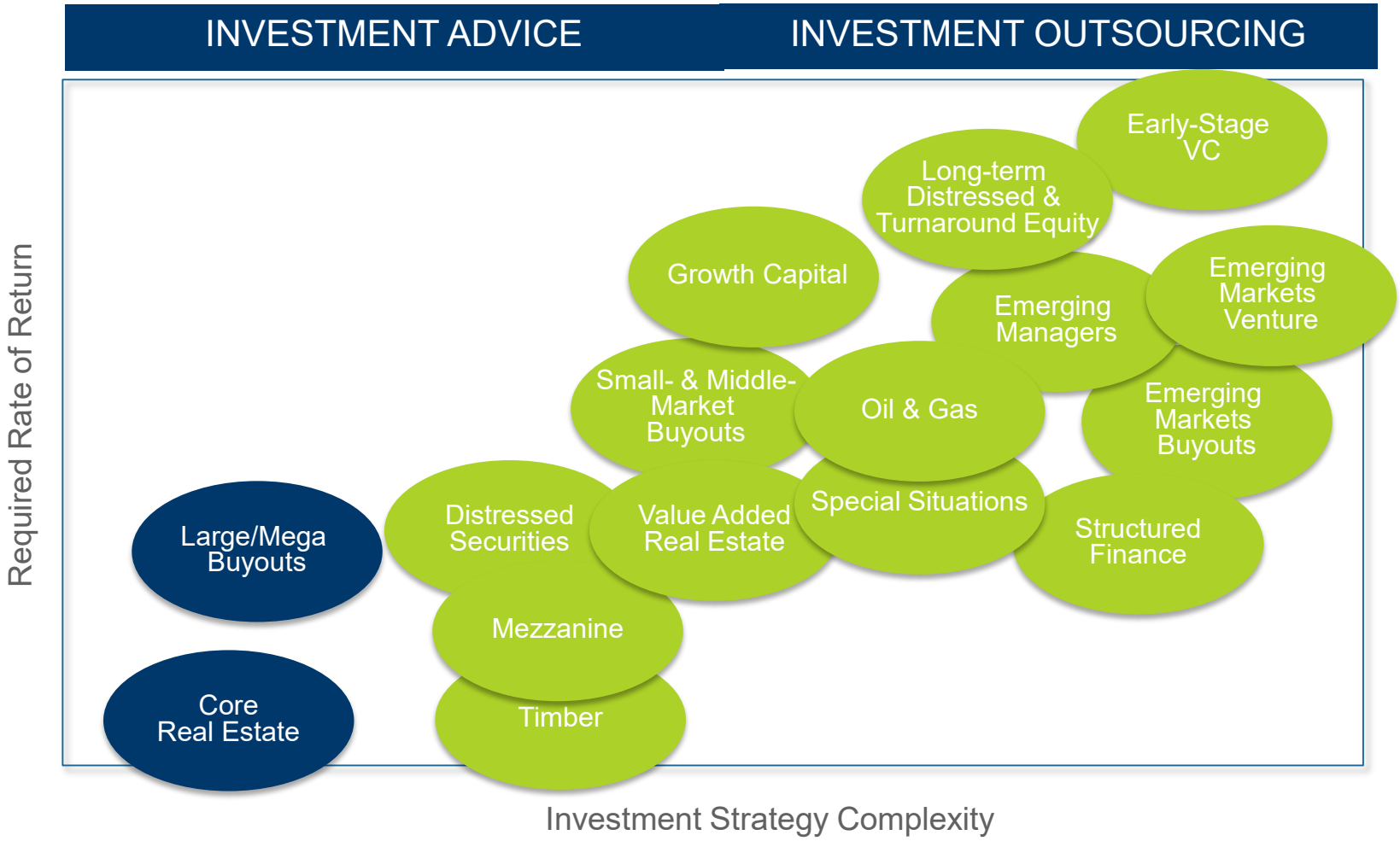
PRIVATE MARKETS OPPORTUNITY SET



- More Efficient Sectors
- Inefficient Sectors

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